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THE POLITICAL ECONOMY OF TRANSFORMATION

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This article gives an analysis of the political economy of transformation which stresses the major achievements of some countries, the fact that the transformation is not yet over, the existence of both winners and losers, and the limitations of transition orthodoxy. Attention is paid to the implications of transformation up till now for social philosophy and the Washington Consensus. It is argued that among the surprises of transformation were the importance of a sound banking system, of a strong, but limited, state, and the fact that transformation is a long and difficult process. In addition, the initial stress on the need for rapid privatization turned out to be one-sided. More important for the resumption of economic growth is the development of new private firms. There are political dangers on the road ahead which, for the successful applicants, will be reduced by EU membership.

I. A MAJOR STEP FORWARD

In a number of countries, the transformation process has made great progress. In those countries, central planning is a matter of economic history, there exist functioning markets for goods and factors of production, the legal and administrative framework for a market economy is in place, a large part of the economy is now in private hands, economic growth has resumed, and the country concerned has demonstrated its attractiveness to foreign private capital. Three central European countries (the Czech Republic, Hungary, and Poland) have already joined the OECD. The negotiations on enlargement of the EU are scheduled to begin next year, and it is widely believed that the three new OECD members and Slovenia have a good chance of joining in the first round and of being members before 2005. Some countries which for various reasons may not join the EU in the first round enlargement (e.g. Slovakia and Estonia) have also made substantial progress in transformation.

Particularly important is the progress made in Poland, the most populous of the central European countries. After a recession in 1990–1, this country has enjoyed steady economic growth from 1992 onwards. Whereas between the mid-1970s and

1991 Poland was in a perpetual economic crisis (Simatupang, 1994), since 1992 it has been one of the most economically successful European countries. Which of the various governments in power in Poland since 1989 is entitled to the credit for this achievement is, naturally, a matter of debate in Polish political circles. In view of the widespread dogma that inflation is harmful for growth, it is noteworthy that Poland's high, by European standards, economic growth has been accompanied by high, by European standards (but declining), inflation.

II. THE TRANSITION IS NOT YET OVER

In some quarters, it is argued that the transformation—at any rate in the leading countries—is already over. This seems somewhat exaggerated. In Germany, although the problems of the five new provinces can now be classified as regional rather than transformational, their failure to generate self-sustaining economic growth and their burden on the federal budget, are still very noticeable. Elsewhere, restructuring has still to take place (e.g. in the Czech Republic), or the pension system has still to be reformed (e.g. Poland and Hungary) or registered unemployment remains high (e.g. Poland and Hungary). As the *Transition Report 1996* (EBRD, 1996, p. 26) sensibly observed,

> even those countries in the region that are most advanced in transformation still face other substantial challenges of reform—for example, in the areas of enterprise and farm restructuring, banking supervision, capital market development, competition policy, utility pricing, labour market regulation, social security, secured transactions and broad areas of the legal structure. Much has been achieved but much remains to be done.

An important topical issue is that of the graduation criteria, i.e. by what criterion/criteria will we know that the transformation countries have completed the transformation class and become 'normal' economies. A variety of criteria have been suggested. They include: the replacement of bureaucratic by market coordination of economic activity; the emergence of an enterprise sector which in its ownership, financing, and behaviour is clearly of the modern capitalist type; attainment of the pre-transformation level of output; attaining the development level of the EU countries; sufficient institutional changes so that the transformation is irreversible; the transition from receiving help to giving it; membership of the EU; and so on. It is already obvious that some countries will graduate quite soon, while others will do so only a long time in the future, or will leave school without a diploma.

III. WINNERS AND LOSERS

There has been considerable discussion about the development of living standards in the transformation period (Adam, 1993; Sachs, 1993, 1995; UNICEF, 1993, 1994,1995, 1997; Kabaj and Kowalik, 1995). Although official statistics in many countries show a sharp fall in average living standards, often extending over several years, some writers have expressed scepticism about the reality of this fall in view of the ending of shortages, the increased variety of goods and services available, the increased ownership of consumer durables, and the very visible winners. However, the picture given by official economic statistics is confirmed by social indicators. For example, transformation has turned out (except in Poland) to be a demographic crisis (Ellman, 1997). Many of the transformation countries (but not Hungary, Albania, the Czech Republic, Poland, and Slovenia) have experienced declines in the crude birth rate greater than that in Germany during the Great Depression, and a number of countries have experienced increases in the crude death rate greater than that of the USA in the wake of the Great Depression.[1] Evidently, a large part of the population of these countries has experienced the transformation as a major social shock with significant negative elements.

The losers have tended to include older (former) employees, those working in agriculture, manufacturing, coal mining, and the state sector, the newly unemployed, ethnic minorities (e.g. Romanis or Russians living outside Russia), children, large families, and the less educated. As Szamuely (1997, p. 14) has noted,

[1] The country with the biggest increase in the crude death rate in 1989–94 was Russia. Part of this increase was caused by demographic and social factors unrelated to the transformation process.

Summing up, in Hungary today the best chance of avoiding poverty falls to those who went on to some kind of secondary education or vocational training, who are not Gypsies, who do not live in a village, have no children or other dependants, and who, of course, have a job.

The losers often form a large part of the population, particularly in rural areas. (The winners tend to live in, or at any rate work in, the capital city.) One result of the existence of both winners and losers was a big increase in inequality in the early transformation period. According to Milanovic (1994),

> On average, income inequality has increased by around 5 to 6 Gini points, from about 24 in 1987 to about 30 in 1993, with the greatest increases in the Baltics, followed by Russia, Bulgaria, the Czech Republic and Poland. . . . This five-to-six point increase is about half of what occurred in the United Kingdom during Margaret Thatcher's ten-year rule. In Eastern Europe and the FSU, however, the change occurred in four to five years, so the intensity of change was about the same. A Gini coefficient of 30 is still not high, relative to many middle income countries, but exceeds that in many OECD countries, among them the Scandinavian countries, Belgium, Holland and Germany.[2]

As well as the increase in inequality within countries, it is likely that there has also been an increase in inequality between countries.

In addition, during the initial transformation period there appears to have been a massive increase in poverty, at any rate using an income-based measure of absolute poverty. According to Milanovic (1994), using a single absolute poverty line ($120 per capita per month at 1990 international prices), between 1987/88 and 1992/93, the number of poor in central and eastern Europe rose by 50m, increasing from 3 to 18 per cent of the population. If one excludes the former Soviet Union (FSU) (which appears to have been hit particularly badly) and just looks at central and south-east Europe (Milanovic, 1996), then using this measure the number of poor in this period more than quadrupled, increasing from 3.6m to 18.7m. This increase was concentrated in Poland, Romania, and Bulgaria. The increase in poverty was a result of a decline in average incomes combined with greater inequality. Although precise estimates of the number of poor always depend heavily on precisely where the poverty line is drawn, the qualitative picture painted by Milanovic is accepted by the World Bank (1996, ch. 4) and seems fairly robust.[3]

For Poland, using the Leyden Poverty Line, there was a high level of poverty in the early 1990s (40 per cent in 1993—about twice as high as Milanovic's absolute poverty in that year) but a sharp fall in 1993–5 (to 31 per cent in 1995). Expenditure-based measures of relative poverty in Poland show a rough plateau in 1993–5, and income-based measures of absolute poverty a slight increase (OECD, 1997, p. 91).

IV. HOLISTIC SOCIAL ENGINEERING REVISITED

In his well known books, *The Open Society and its Enemies* and *The Poverty of Historicism*, Popper argued against holistic or Utopian social engineering and in favour of piecemeal social engineering. In many respects, the transformation, of course, is an example of just that holistic social engineering that Popper attacked. Neo-liberals, armed with their doctrines and sure that they are right, have attempted to rebuild entire societies quickly according to a blueprint, the Washington Consensus (William-

[2] More recently, at any rate in Poland, the situation has been different. In Poland, the Gini coefficient seems to have peaked in mid-1994 and then begun to decline, together with other measures of inequality, such as the decile ratio (OECD, 1997, pp. 84–90).

[3] The Milanovic results are, however, naturally sensitive to the years selected for comparison, the data used, and the poverty concept used. For Russia, if the data used are those of the Erasmus Household Survey (for 1991) and the Russian National Panel Survey (for 1993–5), and the poverty line is the Leyden Poverty Line, then, whereas throughout 1991–5 the overwhelming majority of the population were in poverty, the proportion in poverty decreased slightly in 1991–5, from 83 per cent to 78 per cent (Frijters and van Praag, 1997). Using a half mean definition of poverty, and using the same data, poverty declined in this period from 25 per cent to 18 per cent, and using a half median definition, from 17 per cent to 10 per cent. There are, however, a number of problems with the 1991 data set, so that it is unclear to what extent it is, in fact, representative of the incomes or welfare of the Russian population at that time. Moreover, the 1991 data were collected at the end of 1991, when the USSR was breaking up and the economy was in acute disequilibrium, and hence do not form a very good basis for comparing Soviet and Russian income distributions. In 1994, when participants in the National Panel were asked to compare their well-being in 1994, during perestroika and before 1985, only 6 per cent thought they had been better off under perestroika, but 66 per cent thought they had been better off before 1985 (Frijters and van Praag, 1997, Table 7).

son, 1994). Unlike what Popperians expected, holistic social engineering in a considerable number of countries has turned out to be quite successful. This indicates that there are two types of holistic social engineering, Utopian and imitative.

Utopian holistic social engineering attempts to reconstruct society according to a blueprint which exists in the minds of the movement doing the engineering, but which has never existed in any actual society and may be unfeasible. Popper's critique remains valid in this case. Imitative holistic social engineering, on the other hand, attempts to reconstruct society by taking over more or less *in toto* the institutions and policies of a system which actually exists somewhere else and is successful there. Although some aspects of Popper's critique are also valid in this latter case, experience in the transformation has shown that under certain conditions this type of holistic social engineering is feasible. Furthermore, writers such as Balcerowicz (e.g. Balcerowicz *et al*., 1997) have argued that it is advantageous since, at moments of regime change ('extraordinary politics'), there is a 'window of opportunity' (Roland, 1994; Frydman and Rapaczynski, 1997) which makes it possible to do quickly what at other times would be difficult and lengthy to implement.

V. DIVERSITY IN TRANSFORMATION

There has been a wide diversity in transformation experience (Csaba, 1995). Countries have pursued different exchange-rate policies, different privatization strategies, and different labour-market policies. The general picture has been that the more economically and socially advanced countries, and the ones with the most favourable geographical location, have fared best and the ones with lower levels of development and a less favourable geographical location and political and administrative inheritance, have fared worst. The benefits of a border with the EU have been very clear (for example in the Czech Republic's large tourist earnings or Poland's large 'border trade'). On the other hand, Bulgaria, located on the wrong side of the war in former Yugoslavia, was particularly hard hit by that war and the blockade against Yugoslavia.

Although, in general, unemployment has risen to high levels by the standards of the old regime or the more successful EU countries, in the Czech Republic it has remained low. The latter experience seems in part to reflect the persistence of soft budget constraints and in part the short duration of unemployment benefits (Jackman and Pauna, 1997).

The diversity of experiences has been very positive, since it has enabled comparisons to be made between different policies and also thrown light on the relative importance of policy and structural factors in determining outcomes. As a well known textbook sensibly observes (Gros and Steinherr, 1995, p. 92),

> The problems that arise in the implementation of reform programmes vary from country to country. They depend on the strength of the administrative machinery inherited by the reformers, the overall political situation and the popular support for reforms. Differences in these factors are in our view more important in explaining the huge differences in the fate of the reforms in Central and Eastern Europe than differences in the intellectual concepts behind the reforms. The Czech Republic and Russia might serve as the two extremes.

As a result, similar economic packages, of the 'shock therapy' variety, introduced in Yugoslavia in 1989, Poland in 1990, Czechoslovakia and Bulgaria in 1991, and Russia in 1992, were failures in Yugoslavia, Bulgaria, and Russia[4] but much more successful in Czechoslovakia and Poland.

VI. SURPRISES OF TRANSFORMATION

One of the surprises of transformation has been how much the populations of those countries have been prepared to put up with. The uprising in Albania in 1997 has been exceptional. Although in some countries (e.g. Hungary and Poland) there has been a 'normal' alternation of parties in power, in

[4] Although a failure as a *stabilization* package, the Gaidar measures were quite successful as a *liberalization* package. Furthermore, considered as a stabilization package, the Gaidar package was orthodox (it lacked a fixed exchange rate and stringent wage controls) rather than heterodox (as, for example, in Poland). For a comparison of orthodox and heterodox stabilization packages, see Bofinger *et al*. (1997).

others (e.g. Russia) so-called reformers have been able to cling on to power despite the widespread suffering which a large part of the population has experienced.

Another surprise has been the importance of the banking sector and of financial fragility. With some exceptions (e.g. Brainard, 1991) there was little attention in initial policy proposals and policy discussion to the role of the banks. Experience, however, has shown that banks play a very important role in the transformation. They provide (or fail to provide) the payments transmission system, their bad loans can burden the state budget (as in Hungary) or precipitate a deep economic crisis (as in Bulgaria), they can play a positive role in the work-out of overdue loans (as in Poland), and poor supervision and regulation of their activities may permit spectacular banking collapses with negative economic consequences (as in the Baltic states and the Czech Republic). Fraudulent 'investment' schemes have been a widespread problem and in one country (Albania) even precipitated a national uprising.

Another surprise has been the need of a market economy for a limited but strong state, for an effective public administration. Although the OECD, with its SIGMA programme, was quick to recognize this need, the general tendency among local neo-liberals and their international backers was to concentrate on building the market sector and neglect the need to maintain and develop the state. Research on the Hungarian banking sector led Abel and Bonin (1993) to point out the dangers of state desertion. By 1997, even the managing director of the IMF had drawn attention to the danger to the transformation process from state collapse.[5] The decay of the state, which has been such a feature of developments in the Commonwealth of Independent States (CIS) countries, has been a serious problem in fields ranging from taxation to public health, from education to crime. Corruption, failure to establish a state monopoly of force, and inadequate funding of essential public services, have been only too common.[6]

Another surprise is that the transformation is a long and difficult process. In 1989 both the general public and the profession were too optimistic about the cost and duration of the transition to capitalism (Gomulka, 1993, p. 188; Portes, 1994). The excessive optimism of the profession partly reflected the inattention of many economists to institutions and the specificities of the institutional inheritance of the transformation countries and their confusion between comparative statics and dynamics.[7]

Yet another surprise—but not to Kornai (1992)—has been the unimportance for economic growth of the rapid privatization of the inherited large state-owned enterprises. The need to privatize such enterprises quickly was an article of faith of the Washington Consensus, but turned out to be much less important for economic growth than stimulating the rapid development of new private firms (Johnson and Loveman, 1995; Winiecki, 1996).

VII. TRANSITION ORTHODOXY AND ITS CRITICS

Transition orthodoxy has simply been the application of the Washington Consensus to a new issue—the transformation of the former state socialist countries into modern capitalist ones. The main elements on the economic front were stabilization, liberalization, and privatization.

Stabilization turned out to be full of pitfalls and trade-offs. A fixed exchange rate turned out to be a useful element of stabilization packages, but if adhered to for too long led to real appreciations which under-

[5] In January 1997 the managing director of the IMF stated, with special reference to Russia, that 'No-one measured the true depth of the collapse of all administrative structures, the decomposition of the state which accompanied the collapse of the communist system.' (*Financial Times*, 10 January).

[6] According to the Russian economist Khanin (1997), 'Any kind of economic revival of Russia is impossible without the creation of a minimally efficient state, which is able to formulate and implement a carefully thought out economic policy, collect taxes and struggle against crime. The Russian state is yet another, and for society the most dangerous, of the soap bubbles created in postsocialist Russia.'

[7] Not everyone made this mistake. Already in 1990, when visiting the USSR, Mrs Thatcher confirmed, on the basis of her own experience, the view expressed by the then Soviet deputy prime minister responsible for economic reform, L. Abalkin, that reform would be painful. See Ellman and Kontorovich (1998, ch. 7).

mined the current account and economic growth. In Russia it took five years to reduce inflation to a more or less civilized level (22 per cent). This resulted from inadequate political support for rapid stabilization and structural features of the economy (a market-incompatible geographical location of economic activity, large sectors of the economy for whose output there was little or no demand in a market economy, e.g. the defence and space sectors, the small size of the pre-existing private sector, and the lack of a market-friendly system of economic institutions and of public administration).

There was a trade-off between instant convertibility and inflation, since instant convertibility required deeply undervalued exchanges rates. Deeply undervalued exchange rates contributed to inflationary explosions at the beginning of many 'stabilization programmes'.

Nevertheless, IMF-backed stabilization programmes, if persisted in, eventually led everywhere to a sharp decline in inflation levels. Sceptics have suggested (Taylor, 1994, p. 72) that 'inflation is a riddle that economists have been conspicuously unable to resolve.' Actually, conservative fiscal, monetary, and exchange-rate policies, combined with trade liberalization, in an international environment characterized by sharp competition and approximately stable prices, have proved, where persisted in, everywhere capable of reducing inflation sharply.

Liberalization of prices, of internal and external trade, and of the rules governing the establishment of private firms, were essential elements of the initial steps towards a market economy. Nevertheless, there were also trade-offs and pitfalls here. The more complete the initial price liberalization, the bigger the initial price explosion. Liberalization of internal trade cluttered up the central areas of big cities with small traders. Complete liberalization of international trade was often followed by the reintroduction of some protectionist measures.

As far as privatization is concerned, a trade-off between speed and effectiveness has emerged. Where the emphasis was placed on speed (e.g. in Russia or the Czech Republic) restructuring has tended to lag behind. Furthermore, in perhaps the most successful transformation country (Poland) growth has largely come from newly created private enterprises (sometimes using assets which previously were in the state sector) rather than from the privatization of existing large state-owned enterprises (which has turned out to be a lengthy and complex process). Furthermore, there is a trade-off between speed of privatization and fiscal receipts. Quick, voucher, privatization is possible, but does not bring the benefits to the budget of a slower process of sale.

Transition orthodoxy has been much criticized (McKinnon, 1993; Amsden *et al*., 1994; Nolan, 1995; Laski and Bhaduri, 1997). Much of the criticism has been irrelevant for the actual situation existing in the countries concerned. Perhaps the most relevant criticism has come from those who accept the need for rapid change and much of the orthodox policy framework, but who with the benefit of hindsight have offered detailed critiques of policy implementation and policy results (Kolodko, 1992; Kolodko and Nuti, 1997).

What was wrong with 'shock therapy' was not the idea of ending very rapid inflation quickly (this is desirable), nor its stress on the introduction of free prices and free enterprise (which are also desirable), but its neglect of the interrelationship between monetary and real variables, its application to issues that inevitably take time (e.g. institution building), and its neglect of social policy (Eatwell *et al*., 1995, ch. 4; Orenstein, 1996) and of the need to maintain and develop state capacity.

What was wrong with 'gradualism' was that in some cases (e.g. in the Ukraine) it was a euphemism for postponement, which spread the pain over a long period, postponed recovery, and contributed to a deep depression.

What was wrong with the application of these labels to particular countries is that no country applied exclusively either the one or the other. As Portes (1994, p. 1180) observed, 'no country fits the stereotype particularly well: "gradualist" Hungary was much more "radical" than Poland in its implementation of bankruptcy legislation, and Czechoslovakia more "radical" than either with its voucher privatization programme.'

Furthermore, experience has shown (see section V, above) that differences in economic policy ideas have only played a limited role in determining differences in outcomes.

The result of the experience of many countries and of the international policy debate has been the gradual emergence of a new conventional wisdom (World Bank, 1996; Kolodko and Nuti, 1997, section 12). This recognizes the surprises, pitfalls, and trade-offs mentioned above. It has dropped the insistence on rapid privatization of the inherited large state-owned enterprises and a positive real interest rate. It continues to stress the need for fiscal discipline, rapid price and trade liberalization, and for quickly bringing inflation below, say, 40 per cent p.a. It recognizes the importance of an efficient public administration, effective corporate governance, an efficient and solvent banking system, and of new private enterprises, the usefulness in some circumstances of modest tariff protection, and the importance of public goods and affordable transfer payments or wealth transfers (e.g. agricultural land). It also recognizes the importance of political and geographical factors in determining economic outcomes.

VIII. STATISTICS AND REALITY

The immediate result of the application of transition orthodoxy to the countries of central and eastern Europe, was to produce a very sharp fall in their output, as measured by their national statistical offices. This gave rise to a prolonged debate about the extent to which these statistics gave a good picture of reality. This applied in particular to Russia, where at the beginning of the transformation the quality of the statistics was particularly bad (Granville and Shapiro, 1994; Koen, 1996). In general, it seems that output did fall significantly, though often less than shown in initial official statistics. In some cases, the output falls were really spectacular and show that the countries concerned were hit by a deep and prolonged depression. For example, in Russia, according to the World Bank–Goskomstat recalculations (World Bank, 1995), GDP in 1990–4 fell by 35 per cent. Since output also fell in 1995 and 1996, the total output fall was even greater, and compares adversely with the experience of most countries in the Great Depression.

What was the welfare implication of these falls? It is often argued that, unlike the situation in a mature market economy, it cannot automatically be assumed that less output means less welfare, since much of the production under the old system was a result of low efficiency (e.g. excessive materials and energy intensity of production, or excessive stocks) or was not viable in a market economy (e.g. Trabant cars or most Soviet televisions). This argument is partially correct, but ignores the fact that, in a closed economy, internationally uncompetitive goods may still be valued by the population. Direct measurement of social indicators by UNICEF (1993, 1994, 1995, 1997) shows a marked deterioration in many countries, but much worse in the FSU than in central Europe.

IX. SUCCESS CRITERIA

A widely used success criterion for evaluating the performance of the transformation countries has been economic growth, as measured by GNP statistics. Experience has shown this can be a one-sided criterion, which gives inadequate attention to institution building and socio-political evolution. This was demonstrated dramatically in 1997 by events in Albania, a country which by then had completed four years of economic growth. Similarly, in Romania after economic growth in 1993–6, electoral politics led to a large monetized fiscal deficit in 1996 and hence a reversal of the very steep 1993–5 decline in inflation and what had seemed like the attainment of financial stabilization. Successful transformation is not just a matter of resuming economic growth but also of developing market institutions, responsible political actors, and stable and attractive socio-political systems.

X. POST-COMMUNIST TRANSFORMATION AND POST-WAR RECONSTRUCTION

It has often been remarked that transformation policy in central and eastern Europe has differed substantially from post-war reconstruction in western Europe. Instant convertibility, instant price liberalization, rapid reduction of subsidies, and rapid privatization, were not characteristic of post-war reconstruction in western Europe. Instead, there was major attention to employment and distributional aspects of policies. To suppose that one set of policies was optimal and generally applicable, and the other was mistaken, ignores the fundamental structural differences between the two periods. First, the domestic political situation differed fundamentally between the two experiences. The politicians who came to power at the beginning of the transformation were revolutionaries, anxious to sweep away the institutions of the old regime and introduce something quite different. In this they differed from many western European politicians in the post-war period who remembered the pre-war depression and aimed at social peace. Whereas politicians in much of post-war western Europe were anxious to reduce the appeal of Communism by attractive social policies, in the transformation period, Communism no longer existed (except in Russia—and even there only as an opposition) and liberal politicians and their international backers were free to 'build capitalism' (Bauer, 1991).[8] Second, the international environment differed fundamentally. In recent years both the international financial institutions and intergovernmental organizations such as the EU, supported neo-liberal policies. After the end of the Second World War, on the other hand, the United States and the newly created Bretton Woods institutions supported quite different policies. One of the conditions of receiving US help under the Marshall Plan was that the recipient draw up a plan showing how the money would be used and how the economy would develop with the help of the additional resources. Furthermore, the role of multinational companies and the international capital market is enormously greater now than then. These considerations illustrate the role of structural factors in determining sensible economic policies.

XI. POLITICAL DANGERS

The transformation process is still vulnerable to political backsliding, resulting from electoral politics, authoritarian temptations, the social costs of transformation, and the influence of inherited elites. There have already been a number of examples of this. The *Transition Report Update 1997* noted that 'developments in 1996 have shown that market liberalisation can be reversed in countries where there is limited political commitment to reform' (EBRD, 1997, p. 23). Populists coming to power could still, in many countries, derail the transformation process. Given the neglect, relative to western Europe after the Second World War, of social and employment policy, and the growth of inequality, poverty, and unemployment, they might have quite a wide social basis. One way of dealing with this danger is institutional, assigning monetary policy to independent agencies, such as an independent central bank or a currency board. Such agencies have been widely introduced and have had a number of the anticipated positive effects (e.g. the stability of the Estonian kroon–Deutschmark exchange rate since 1992, a period in which the rouble has lost more than 95 per cent of its value against the dollar). Nevertheless, they have also had a number of unexpected effects, ranging from the use of monetary policy to stimulate the economy regardless of the inflationary consequences and in defiance of the government (in Russia and Georgia in 1992–3) to the use at one time in the mid-1990s of around 1 per cent p.a. of the GDP in Poland and the Czech Republic to overcome the effects of monetary policies on international capital flows. It remains to be seen how effective the planned currency board in Bulgaria will be in maintaining monetary discipline, and how long it will last.

Two major factors keeping the process on track are money and the prospect of EU membership. Money, both in the form of media ownership and election expenditures, on the one hand, and Western loans (e.g. from the IMF) on the other, has played and is likely to continue to play, an important part in keeping countries on the path of building capitalism. The prospect of EU membership is very important in determining the institutional development of those countries which aspire to it. EU membership is likely to reduce the danger of political backsliding by the successful first-round applicants and contribute to the stabilization of the liberal order in them. Conversely, the effect of rejection in the unsuccessful first-round applicants could be destabilizing. It is therefore important for the EU both to admit a significant number of the applicants in the first round and also to make

[8] There was, however, sometimes a significant difference between the neo-liberal rhetoric and the more socially conscious policies actually pursued. This was particularly so in the Czech Republic (Rutland, 1993; Orenstein, 1996).

adequate arrangements for the applicants that will not join in the first round.

XII. CONCLUSION

A number of transformation countries have made great progress. For them, 'rejoining Europe' has ceased to be just an aspiration and is becoming a reality. Experience has shown that the application of the Washington Consensus is subject to pitfalls and trade-offs but that, under favourable political and geographical conditions, it can contribute significantly to rapid economic liberalization, to sharply reducing inflation, and to creating the conditions for renewed growth in countries in grave economic difficulties, although at a substantial cost. There have been many losers, and inequality, poverty, and unemployment increased sharply in the early transformation period. In the light of experience, conventional wisdom has evolved and now both overlaps with, and differs from, the conventional wisdom of 1989. Experience has shown that imitative holistic social engineering is feasible and, for some people under some circumstances, desirable. Among the surprises of the transformation were the importance of a sound banking system, of a strong, but limited, state, and the fact that transformation is a long and difficult process. In addition, the initial stress on the need for rapid privatization of the large state-owned enterprises has turned out to be one-sided. More important for the resumption of economic growth is the development of new private firms. Economic growth on its own is an inadequate criterion for assessing progress in transformation. The difference between the policies applied in the transition countries and those applied in western Europe after the Second World War, illustrates the importance of structural factors, both political and economic, in determining appropriate economic policies. There are political dangers on the road ahead which, for the successful applicants, will be reduced by EU membership.

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